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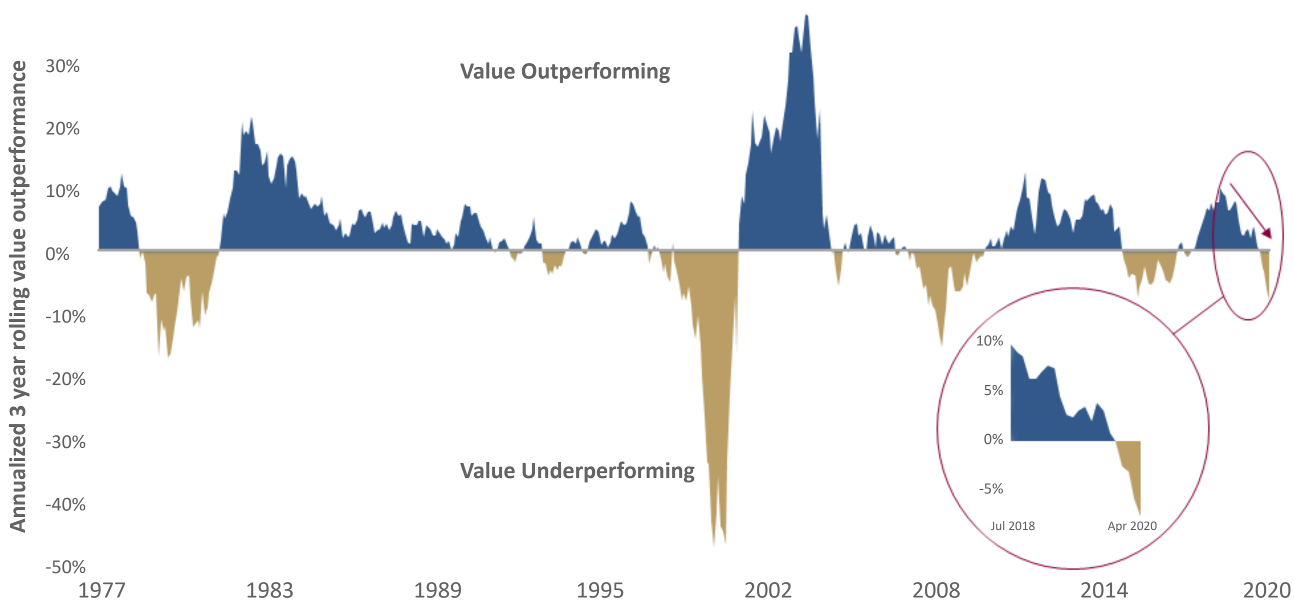
FOYSTON FOR THOUGHT

Does Value Investing Still Work?

Long-term investing in value stocks has produced better returns than investing in growth stocks, historically. However, in recent years, this has not been the case. Does that mean value investing no longer works?

Since 1975, value investing has outperformed growth 68% of time in Canada[1]. However, value stocks began underperforming growth stocks in late 2018 and this has had an adverse impact on longer-term returns.

Value Outperforms Growth 68% of the Time Over 45 Years
(MSCI Canada Value Index vs. MSCI Canada Growth Index)



Source: eVestment

The depth and duration of value underperformance has been felt more acutely in the U.S., where returns for value stocks have lagged growth stocks since 2007. This recent and, in the case of the U.S., prolonged period of growth stock outperformance has caused some market participants to ask, "Is value investing dead?"

The mere fact that this question is increasingly being asked may signal that value investing is on the verge of a return to outperformance. To illustrate the situation, let us first turn back the clock. The phrase "party like it's 1999" was popularized by the Artist Formerly Known as Prince. However, the year 1999 was certainly no party for value investors. By March 31, 2000, the one-year return of the MSCI Canada Value Index lagged the return of the MSCI Canada Growth Index by a staggering 115%. The technology bubble only began in the mid-1990s, yet long term returns for value stocks dating as far back as 15 years were adversely impacted. Then, like now, there was an uptick in debate about whether value investing still worked.

One year later, the tech bubble burst and value investors were finally vindicated. Even more importantly, this outperformance resulted from value stocks providing capital protection in a down market. As you can see in the table on the next page, for the one-year ended March 31, 2001, value stocks gained 25%, outperforming growth stocks, which tumbled 63%. Furthermore, the long-term outperformance of value stocks was restored.

[1] 1975 is the earliest date value and growth style index data is available in Canada. Outperformance is based on annualized 3-year rolling returns. Value outperforms 73% of the time and 89% of the time based on 5-year and 10-year rolling returns over the same time period.

ANNUALIZED RETURNS AS AT MARCH 31	1 YR (%)	5 YRS (%)	10 YRS (%)	15 YRS (%)
2000				
MSCI Canada Value Index	2.4	10.3	8.0	9.2
MSCI Canada Growth Index	117.6	33.4	18.5	14.5
Value Added at March 31, 2000	**-115.2**	**-23.1**	**-10.6**	**-5.2**
2001				
MSCI Canada Value Index	25.0	11.6	9.9	9.1
MSCI Canada Growth Index	-63.2	5.9	7.9	6.6
Value Added at March 31, 2001	**+88.2**	**+5.8**	**+2.1**	**+2.4**

Source: eVestment

Fast forward to today. Investors who had been predicting that a market correction would once again restore value stocks to their glory have been sorely disappointed. After a strong market rebound in April, the MSCI Canada Growth Index ended the month down just 1% year-to-date, while the MSCI Canada Value Index is down 24%. The inability of value stocks to provide capital protection amid the COVID-19 pandemic has further fuelled the debate over whether value investing still works, and has left many wondering "Is this time different?"

The Eulogy for Value Investing Has Been Written Too Soon.

Value investing has fallen out of favour on several occasions over the past century, only to emerge victorious. Despite this history, there are many theories for why this time may be different. The more popular narratives include the technological revolution, low interest rates, growth of private markets, and the obsolescence of traditional measures of value like price-to-book that ignore internally generated intangible assets.

However, multiple studies provide evidence that the eulogy for value investing may have been written too soon. In a research paper by global investment management firm AQR Capital Management titled "Is (Systematic) Value Investing Dead?"[2] the author finds that the evidence to support the above narratives is weak, at best. The paper concludes that "Investors are simply paying way more than usual for the stocks they love versus the ones they hate."

To illustrate this point, let's look at two Canadian companies. Company A has a resilient business track record that spans many economic ups and downs, a healthy return on equity (ROE) and an attractive price-to-earnings (P/E) valuation multiple. Company B has a considerably shorter business track record – mostly during an economic expansion – a negative ROE and trades at a very expensive P/E valuation multiple. Based on these fundamentals, a value investor would conclude Company A is the better investment. Yet shares in Company A have declined 11% this year while shares in Company B have risen 102%. In fact, the market capitalization of Company B – Shopify (SHOP) – recently surpassed that of Company A – the Royal Bank of Canada (RBC) to briefly claim the title of Canada's Most Valuable Company[3].

COMPANY A	versus	COMPANY B
151	YEARS IN BUSINESS	16
126.8B	MARKET CAPITALIZATION	124.7B
14.4%	RETURN ON EQUITY	-5.1%
11.2x	PRICE TO EARNINGS (FWD)	1,406x
1.9x	PRICE TO SALES	50.2x
4.7%	DIVIDEND YIELD	n/a
-11%	STOCK PERFORMANCE YTD	102%

As of May 29, 2020
Source: Bloomberg

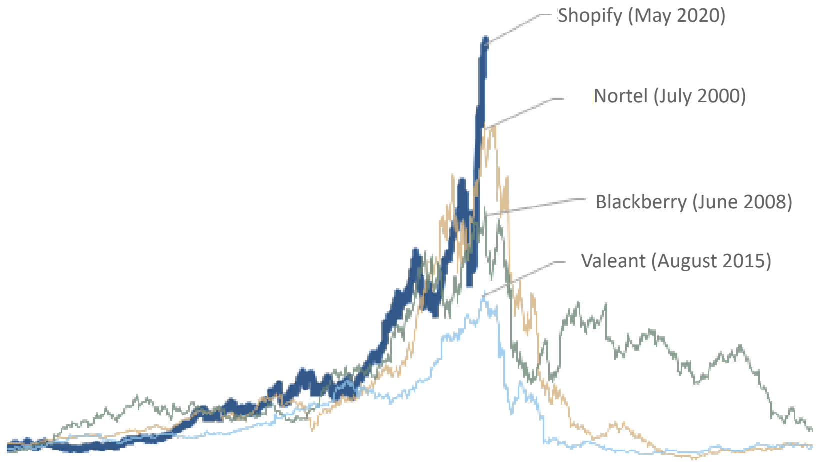
[2] https://www.aqr.com/Insights/Perspectives/Is-Systematic-Value-Investing-Dead
[3] The market cap of SHOP first surpassed that of RBC on May 6, 2020, and exceeded it from May 11 to May 26, 2020 inclusive, based on market close prices.

The Ottawa-based online shopping platform has become the poster child for growth in Canada's technology sector. Shopify's meteoric rise has drawn comparisons to other Canadian companies which at one-time also dethroned RBC:

- the (now defunct) telecom giant Nortel Networks
- handheld device developer Blackberry (formerly Research in Motion)
- drug-maker Valeant Pharmaceuticals (now known as Bausch Health)

It is easy to see why. The graph below compares Shopify's stock price chart to that of Nortel, Blackberry and Valeant. In the case of the latter three companies, irrational investors overpaid for supercharged returns and, as the graph illustrates, share prices subsequently plummeted.

Does History Repeat Itself?



Source: Bloomberg and S&P Capital IQ

Today's value versus growth valuation gap is at an extreme (the 100th percentile of historical relative valuations)[4]. With little to no evidence to support the narratives that "this time is different", the stage is set for potentially historic outperformance of value relative to growth. The issue now becomes, not "if" but "when" value investors will be rewarded.

Going from Shock to Adjustment to Acceptance.

Although the issues driving a crisis are different each time, they do tend to follow a pattern, which NYU's Stern School of Business Professor Aswath Damodaran describes as Shock, Adjustment and Acceptance[5]. It is in the third phase, Acceptance, that value should outperform.

Shock. In this first phase, we identify the issue. During the tech boom/bust (2000-2002), the issue was excess capacity to build out technology. During the Global Financial Crisis (2008-2009) the issue was the U.S. housing market. The issue today is the COVID-19 pandemic. In this phase, considerable uncertainty restricts companies from offering the market any guidance on future earnings.

Adjustment. In the second phase, we have a government policy response. The U.S. government introduced the Troubled Asset Relief Program (TARP) in October 2008 and the Coronavirus Aid, Relief and Economic Security (CARES) Act in March 2020. In this phase, research analysts may begin to adjust downward their assumptions regarding future earnings, but uncertainty remains high.

In these initial two phases of an economic crisis, we normally see the first major decline in the equity markets coupled with dramatically higher levels of volatility. From its market peak on February 12, 2020, the MSCI World Index declined 34% in U.S. dollars before bottoming on March 23. In the following three days, the market increased 17% – marking one of the largest periods of volatility since the Global Financial Crisis. What is common about the first two phases is that the ultimate economic impact is unknown.

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[4] https://www.researchaffiliates.com/en_us/publications/articles/reports-of-values-death-may-be-greatly-exaggerated.html
[5] https://seekingalpha.com/article/4340012-viral-market-update-vii-mayhem-multiples

Value companies tend to underperform during these first two phases of a correction as their fundamentals (revenues, earnings, book value) are based on prior periods, and do not yet reflect the current operating environment. What tends to do best in this phase are quality-growth companies as most people assume the crisis will have minimal or below average impact on these companies' earnings.

Acceptance. In the third phase of the correction we will start to learn more about the impact of the Shock on the economy and individual companies. This phase can last six months, or two reporting periods. Public companies first report the initial impact of the crisis on their profitability, and then the longer-term impact, when adjustments are made in terms of cost structure, indebtedness and liquidity issues. It is in this phase that the markets bottom out as enough is known about this year and next to reestablish company valuations.

Conclusion

Short periods of value underperformance are not only unavoidable but may be a necessary precondition for a return to long-term outperformance. As we move from Adjustment to Acceptance, we expect unloved value stocks will return to favour, while growth companies whose valuations have soared too high too fast will normalize. We have seen evidence of this in recent days and believe that those value investors who have kept the faith will once again be rewarded with a return to long-term outperformance.

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